# Aurimax Investment Club

**Member Newsletter**

**Q1, 2023**

## We Are at a Crossroads

We have reached a crucial juncture where multiple factors are at play. On one hand, the impact of the Fed and other central banks hiking rates is beginning to show in the real economy, evidenced by the collapse of Silicon Valley Bank (SVB) and Signature Bank, causing upheaval in the US banking system, particularly in the local bank sector. The fall of Credit Suisse has also raised concerns about the health of the global banking system. Additionally, the media has been highlighting issues such as public and private debt, potential problems in the real estate sector, and the weakening dollar. Despite the uncertainties mentioned earlier, some positive indicators have boosted the market by 6.17% in Q1 2023. These include the decreasing inflation and the possibility of a recession, which should prompt the Fed to pivot its policies. Due to the uncertainty, our club opted for a cautious strategy, which, combined with the expenses of hedging our portfolio, led to our portfolios underperforming the benchmarks in the first quarter of this year. Nonetheless, we stand by our principle of prioritizing safety first.

The million-dollar question is where the equity market is headed from here, and we recognize that we are at a critical juncture. We are closely monitoring several factors that may influence the market's trajectory, with corporate earnings being one of the keys determining factors in the short to medium term.

## Key Factors Still Argue for an Improving Market Environment

### *The Banking System Worry Is Out of Proportion*

Many individuals have drawn comparisons between the recent SVB crisis and the events that sparked the 2008 financial crisis, specifically the fall of Bear Stearns or even the Lehman moment. However, we believe this crisis is not on the same scale and can be contained if government agencies effectively manage the potential credit crunch. The

root of SVB's problem lies in asset-liability dislocations. Over the years, the bank's startup clients had deposited significant amounts of cash into the bank, which SVB had invested in longer-term government bonds due to the low-interest rate environment. As interest rates rose, the declining values of these bonds resulted in a massive unrealized loss for the bank. When the startup clients withdrew their deposits to maintain their businesses in a challenging IPO and private fundraising climate, SVB faced a capital shortfall and had to sell the bonds at a loss. This led to a panic among depositors, who withdrew their funds, ultimately causing the collapse of the bank. A similar situation occurred for Signature Bank.

Thus, these are problems specific to these banks and their customer clusters rather than a systemic failure of the banking system, as was seen in 2008. The impact of these bank failures is relatively small in the context of the entire US banking system. For instance, SVB's size relative to the current US economy is only 4% as large as the NY-based Bank of the US, which failed in 1941 relative to the then US economy. Moreover, if we combine SVB and Signature Bank, their relative size would still be smaller than the Continental Illinois Bank which collapsed in 1984.

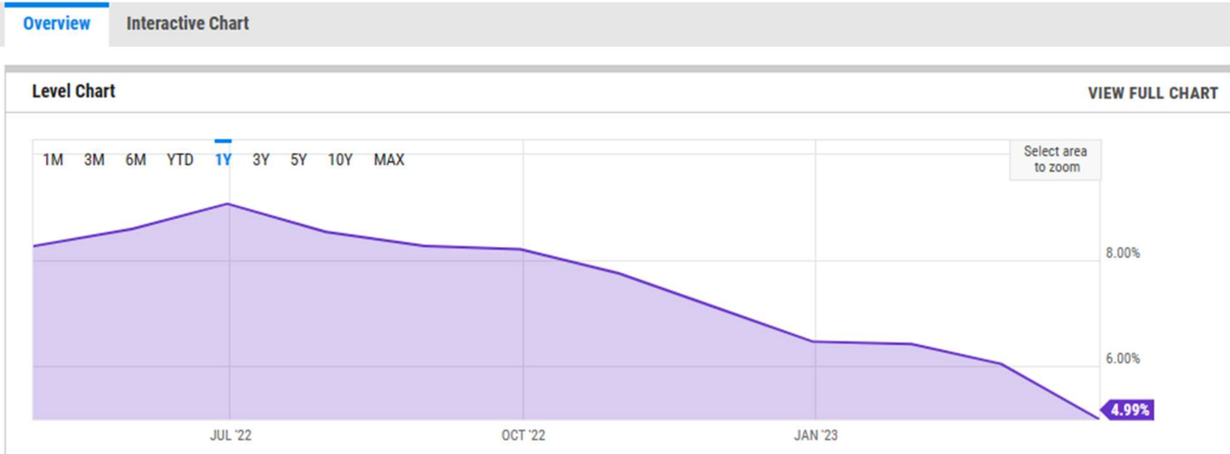
Credit Suisse, has been struggling for years due to a series of scandals, management changes, and significant losses. Hence, it is also a case specific to that bank.

***The Fed Hiking Cycle May Be in the Final Stage***

The US inflation has been consistently decreasing since reaching its peak in July of last year, and this trend continued in March this year. The Consumer Price Index (CPI) increased by only 0.1% from the previous month and 5% year over year, which is an improvement from February and below consensus forecasts. Core prices, which exclude food and energy, rose by 0.4% on a monthly basis and 5.6% annually, in line with estimates. The recent failures of SVB and Signature Bank, along with the possibility of more failures, may impact the Federal Reserve's decision-making. During the March meeting, where the central bank increased rates by 0.25%, officials expressed concern about the banking sector problems and lowered their expectations for rate hikes. Some even considered pausing the rate hikes, indicating that the Fed hiking cycle may be coming to an end.

**US Consumer Price Index YoY (I:USCPIYY)**

4.98% for Mar 2023




*Source: YCharts.*

Looking back at the Fed rate hike ending cycles since 1988, we can observe that, except for the period between 1999 and 2000, which was affected by the 9/11 attacks, each cycle has yielded positive results for both the equity and bond markets. On average, the equity market has risen 157%, while fixed income has increased by 7.4% six months after the pauses.

| | | Equity Returns | | |
|---|---|---|---|---|
| Hiking Cycle Start | # of Months in Hiking Cycle | During Hiking Cycle | 6M After Pause | 12M After Pause |
| 3/1988 | 12 | 11.9% | 25.4% | 19.9% |
| 2/1994 | 13 | 3.0% | 20.5% | 39.2% |
| 3/1997^ | 1 | N/A | 20.7% | 41.6% |
| 6/1999 | 12 | 8.0% | -5.9% | -11.3% |
| 6/2004 | 25 | 15.7% | 12.5% | 20.3% |
| 12/2015 | 37 | 28.5% | 21.0% | 33.2% |
| 3/2022* | 12 | -8.6% | TBD | TBD |
| **Average** | **16** | **9.8%** | **15.7%** | **23.7%** |

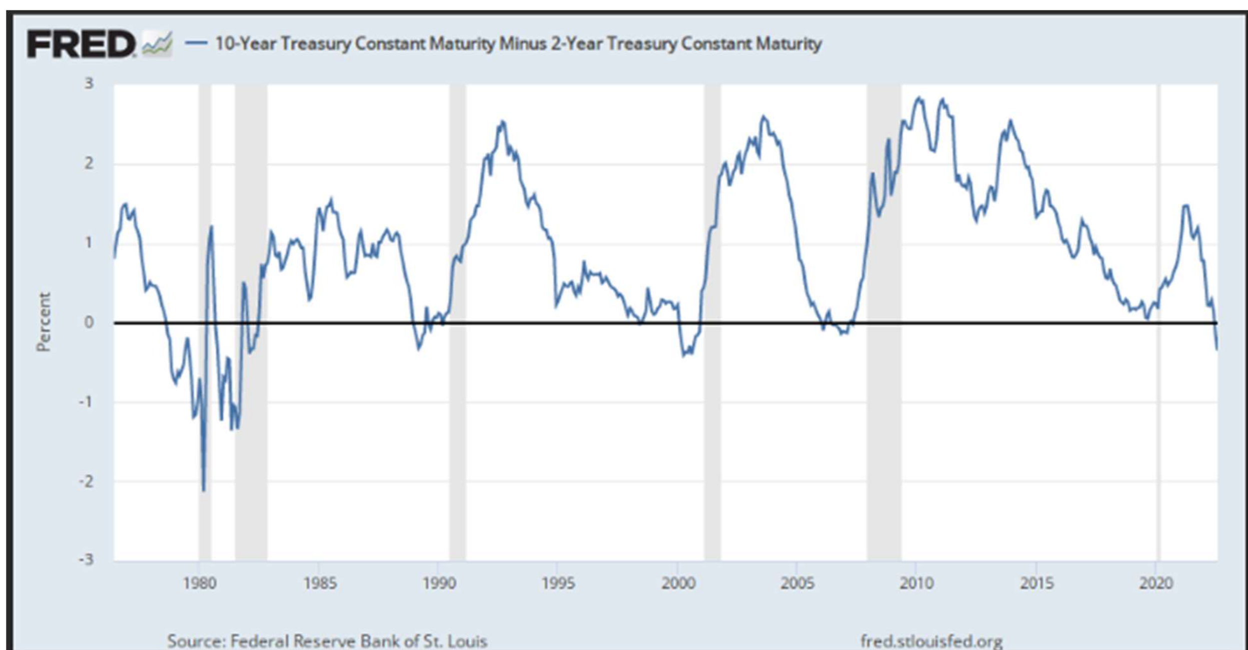
Source: Morningstar as of 2/28/2023. Equity cumulative returns calculated using S&P 500 Index return. See further disclosures at end of document. ^One hike of 25 bps. Federal Reserve paused immediately following single hike. *Hiking cycle has not concluded.

| | | Fixed Income Returns | | |
|---|---|---|---|---|
| Hiking Cycle Start | # of Months in Hiking Cycle | During Hiking Cycle | 6M After Pause | 12M After Pause |
| 3/1988 | 12 | 3.7% | 8.9% | 12.7% |
| 2/1994 | 13 | -1.6% | 9.0% | 17.1% |
| 3/1997^ | 1 | N/A | 6.7% | 11.4% |
| 6/1999 | 12 | 1.4% | 7.7% | 13.7% |
| 6/2004 | 25 | 5.6% | 5.4% | 6.5% |
| 12/2015 | 37 | 5.7% | 6.4% | 9.0% |
| 3/2022* | 12 | -7.6% | TBD | TBD |
| **Average** | **16** | **1.2%** | **7.4%** | **11.7%** |

Source: Morningstar as of 2/28/2023. Fixed income cumulative returns calculated using Bloomberg US Aggregate Index Returns. See further disclosures at end of document. ^One hike of 25 bps. Federal Reserve paused immediately following single hike. *Hiking cycle has not concluded.

***Recession Is Still Possible, but a Mild One***

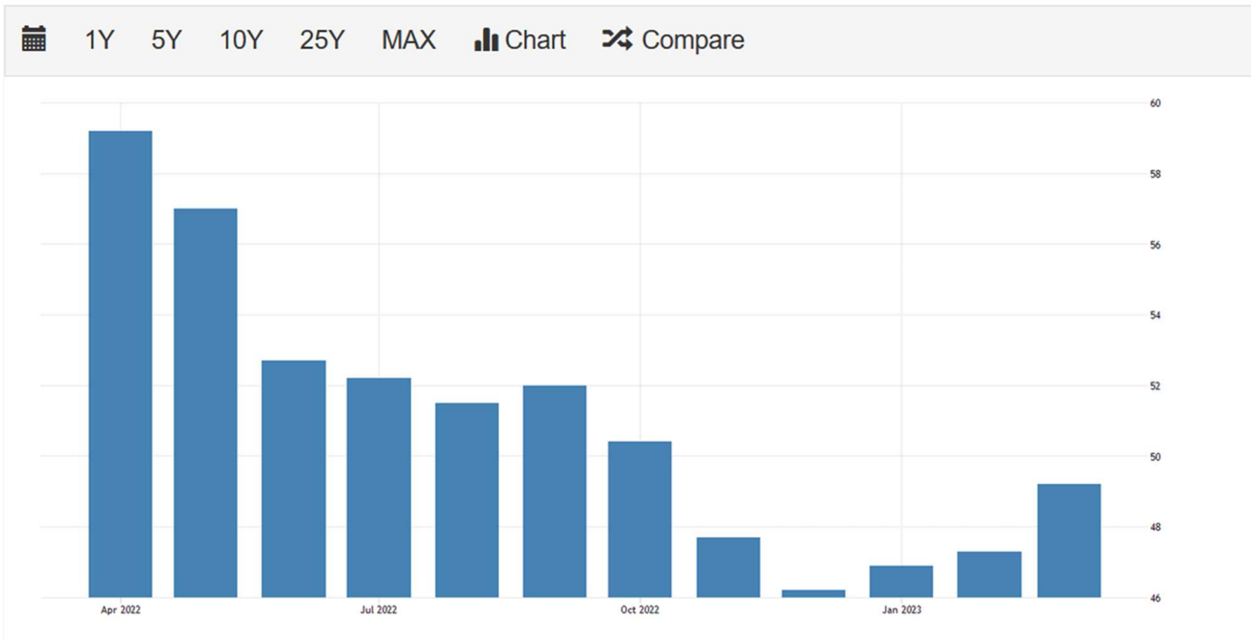
The likelihood of an economic recession remains high as the yield curve remains inverted and steep.




However, we maintain our belief that the impending recession will be mild. This is primarily due to the low unemployment rate, which is at a 50-year low. The creation of new jobs has been robust, and the unemployment rate decreased from 3.6% to 3.5% in

March. Although wage growth has slowed down, the Labor Force Participation Rate has increased. When individuals have job security, they are more likely to spend, invest, and request salary increases, which is crucial since consumer spending accounts for almost 70% of the U.S. economy.

Additionally, the U.S. Manufacturing PMI has gradually improved since reaching its low in December 2022, albeit still in the contraction zone.




***The Geopolitical Tensions Showed Signs of Relief***

The conflict between Russia and Ukraine is ongoing, but there have been some calls for peace negotiations earlier this year. China's Peace Plan, although potentially biased against Ukraine and not entirely realistic, is a step in the right direction.

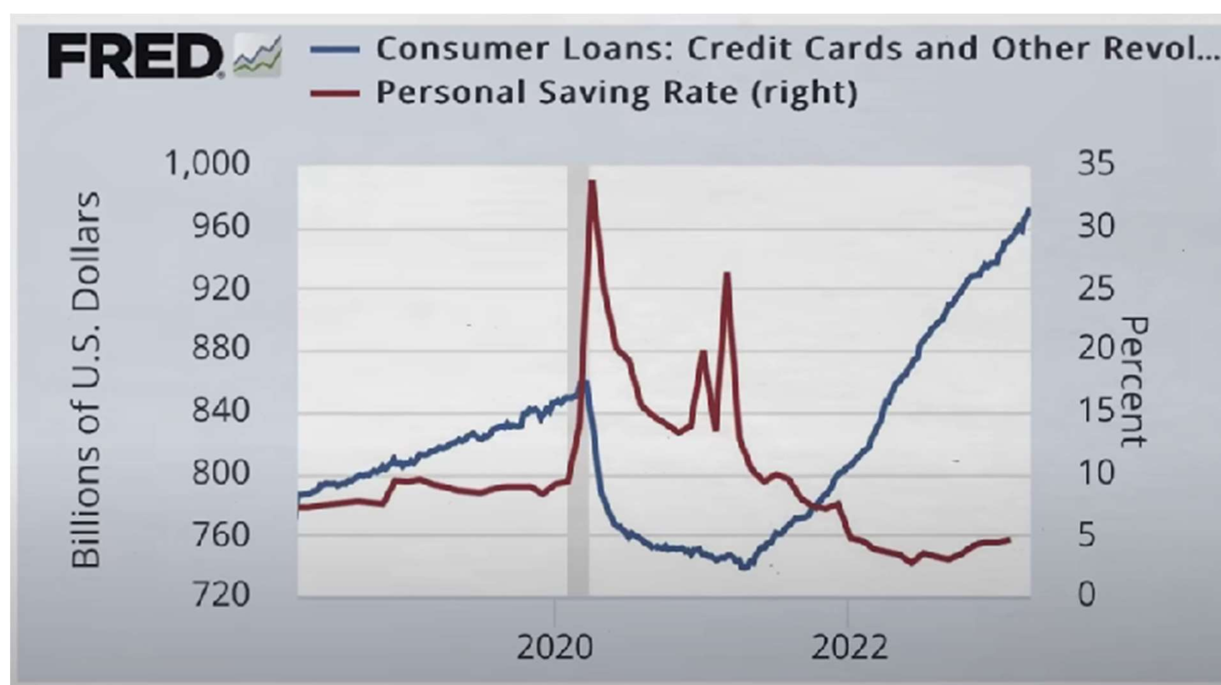
Additionally, our worries about a possible increase in tension in the Taiwan Strait have not come to fruition. Instead of visiting Taiwan, Speaker Kevin McCarthy met with President Tsai Ing-wen during her stopover in California. Notably, none of the US administration officials had a meeting with Tsai Ing-wen. Consequentially, the Chinese military exercises in the Taiwan Strait this year were much smaller in scale than those conducted during the visit of then-Speaker Nancy Pelosi to Taiwan last year.

## Uncertainty and Grey Rhinos

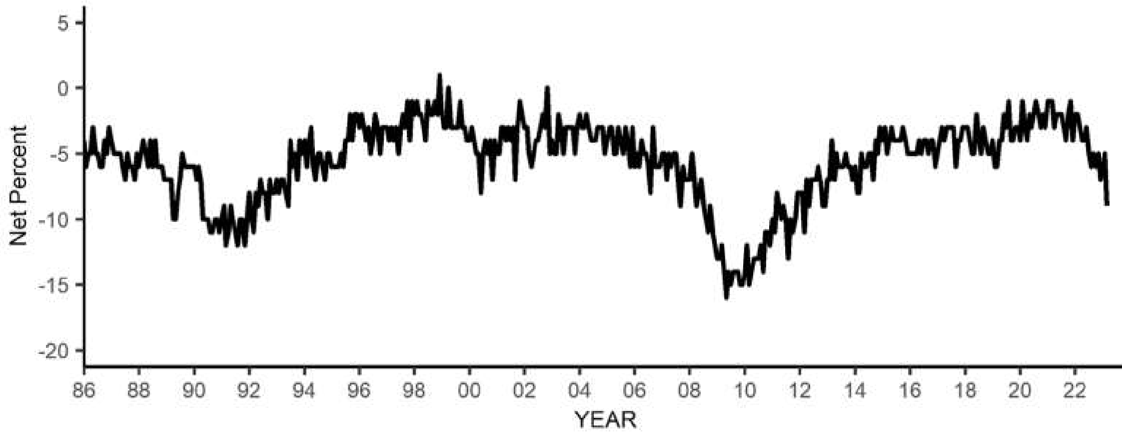
While the market environment for both equity and fixed income has shown promising signs of improvement, we remain uncertain whether the bull is truly back. There are issues that should not be overlooked, such as the high levels of debt and low savings, the possibility of a real estate sector crash, and the impact of the increasing use of local currencies for international trade by various countries on the US dollar in the long run.

### *Low Saving Rate Coupled with High Debt*

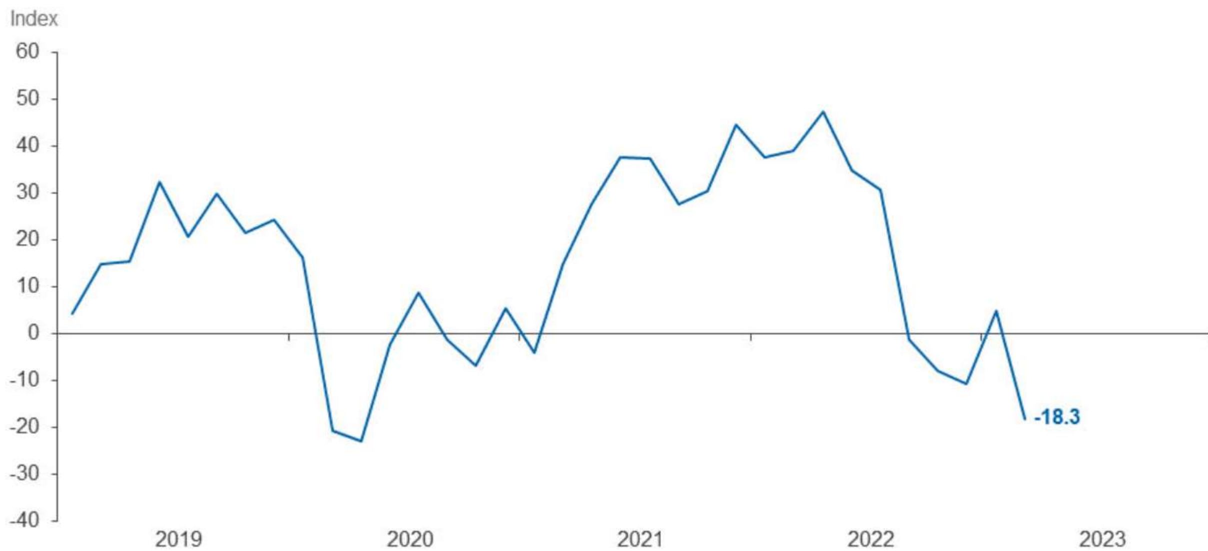
Despite an increase in the U.S. household saving rate from 2022 lows to 4.6% in February 2023, it remains considerably lower than the historical average rate of 8.9% since 1959 and is the lowest level since 2000. Additionally, US households face the challenge of dealing with a record-high credit card debt of nearly $1 trillion, which is becoming increasingly expensive due to rising interest rates. This paints a bleak picture.




U.S. banks have become cautious and are now imposing stricter lending standards due to mounting debt and concerns about a banking crisis resulting from the recent failures of SVB and Signature Bank.




Furthermore, a recent survey conducted by the Dallas Fed, which included 71 banks, revealed a notable decline in loan volume. The deteriorating credit conditions could have long-term adverse effects on the US economy.



### *The Dollar Is Getting Weaker*

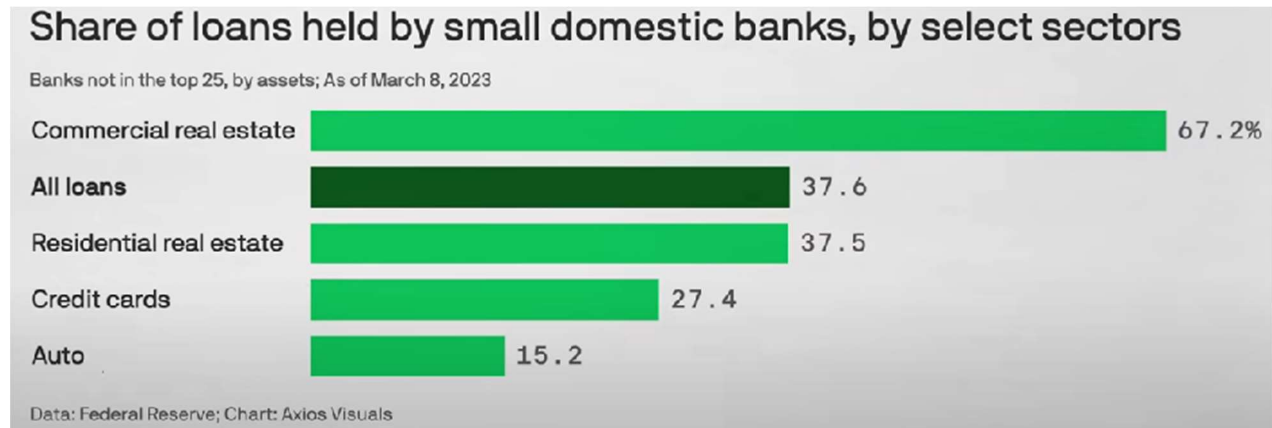
There is another worrying matter to consider, which is the dollar's decline despite the Fed's interest rate hikes. The reason behind this is that an increasing number of countries are engaging in trade using their own currencies, resulting in fewer dollars leaving the United States. As a result, it is becoming more challenging for the US to alleviate its debt by printing more money. Furthermore, with a larger portion of dollars remaining within the country, it becomes more difficult to combat inflation.

*Dollar and US short-term rate: an odd divergence*

### *The Real Estate May Become the Grey Rhino*

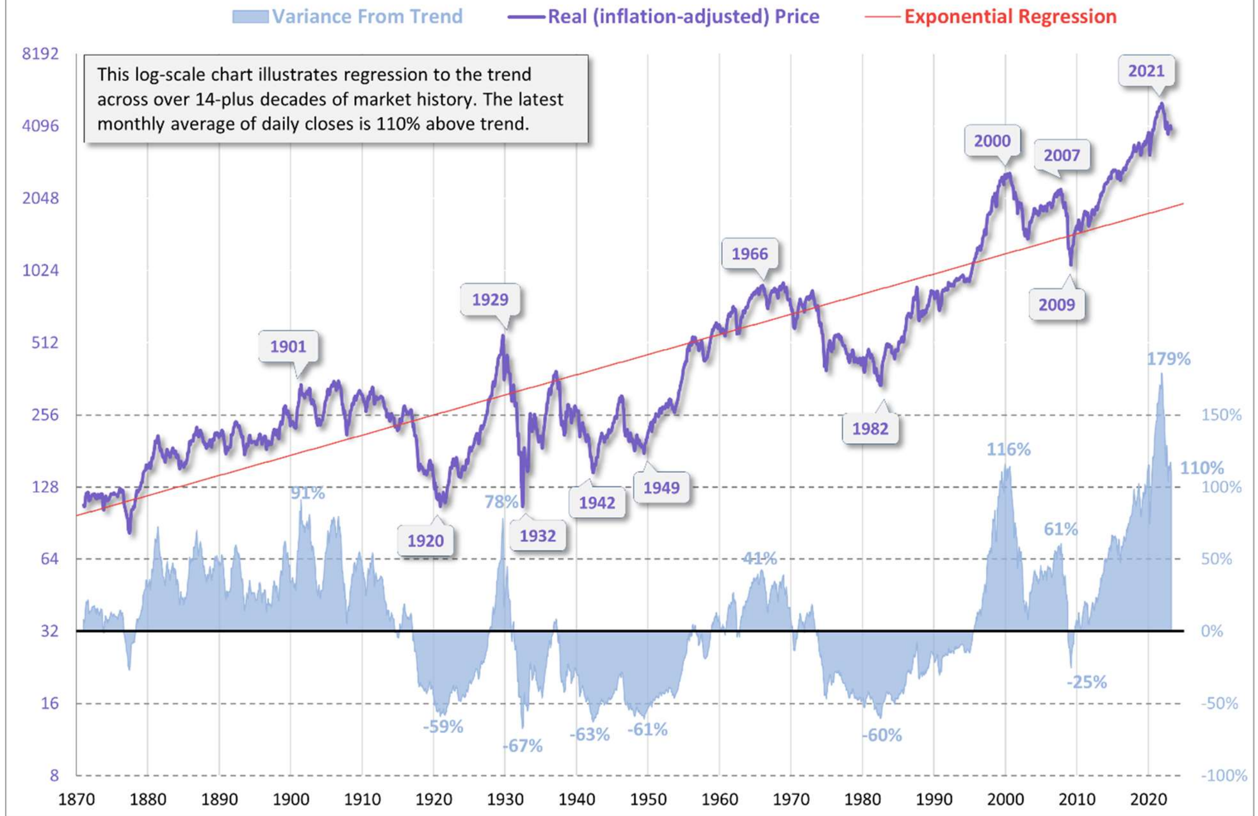
A pressing issue at present is the state of the real estate industry, particularly commercial real estate. By 2025, approximately $1.5 trillion worth of US commercial properties will be due for repayment. With higher interest rates and commercial real estate occupancy rates remaining at 60%-70% post-Covid, Morgan Stanley is highlighting the looming risk of refinancing. They predict that office and retail property values could plummet by up to 40%. Should Morgan Stanley's prediction materialize,

the impact will reverberate throughout the economy, affecting both equity and fixed-income markets. The situation is compounded by the fact that the majority of these loans are granted by regional banks, which are already nervous after the collapse of SVB.




***Equity Valuation Remains in the "Hot" Zone***

We took notice of two charts featured in Advisor Perspective. The first chart portrays the regression of S&P prices, revealing that in March, the S&P Composite was 110% above the historical trend. This is a phenomenon that has not been witnessed since 1870. The second chart is the Q Ratio chart, which shows that although the Q ratio has decreased from its 2021 peak, with a current reading of 1.3 compared to the historical average of 0.8, the present valuation is still 162.5% above the stock market's fair value.


VettaFi Advisor Perspectives
advisorperspectives.com
As of March 2023
S&P Composite Index: Regression to Trend
Variance From Trend
Real (inflation-adjusted) Price
Exponential Regression
This log-scale chart illustrates regression to the trend across over 14-plus decades of market history. The latest monthly average of daily closes is 110% above trend.
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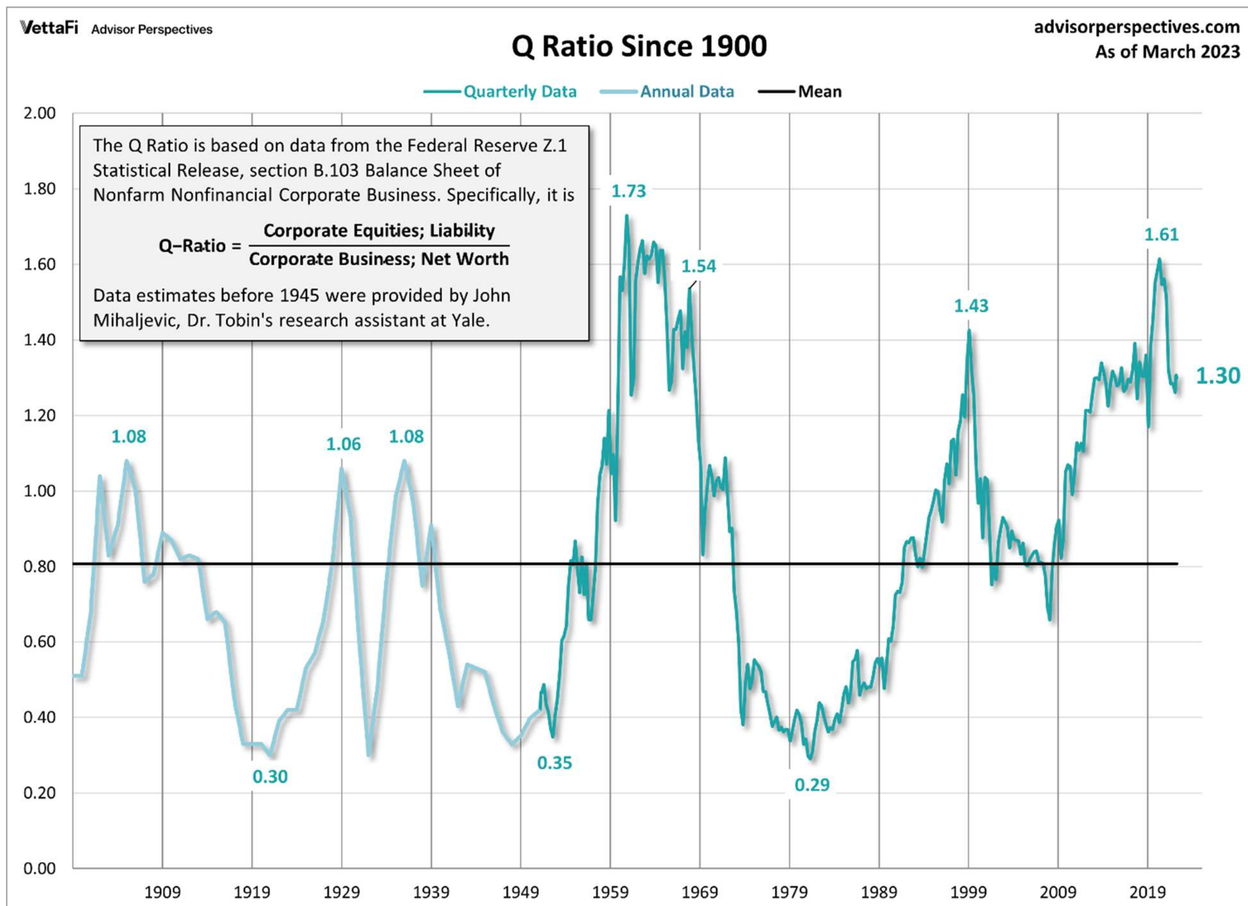


### Aurimax Investment Club Q2 2023 Investment Guideline

Although neither of the above charts provides valuable insight into short-term investment strategies, they are useful in establishing expectations for the stock market's long-term performance. Therefore, the success of the forthcoming bull market will depend on earnings.

Our readers may remember that we hold a conservative view on the earnings of US corporations. While we anticipate a gradual recovery in S&P EPS towards the end of 2023, owing to factors like lower inflation, a potential pause in the Fed's rate hikes, and China's economic rebound post-pandemic, we anticipate a lackluster first half of the year. Therefore, we plan to maintain a prudent investment approach for Q2 2023 until we witness an improvement in the earnings outlook.